Attachment 1

WILSHIRE CONSULTING

Michael C. Schlachter, CFA
Managing Director

August 28, 2006

Mr. Russell Read
Chief Investment Officer
California Public Employees' Retirement System
400 P Street, Suite 3492
Sacramento, CA 95814

Re: International Equity Contract Renewal Recommendation[1]

Dear Russell,

You requested Wilshire's opinion with respect to Staff's recommendation pertaining to the annual review and renewal of the contracts of the international equity managers. Wilshire concurs with Staff's recommendations, and our comments regarding all 18 active and enhanced international equity managers are below. SSGA's passive portfolio is currently in transition to the internal index team, and we recommend renewing its contract until the transfer of assets can be completed.

Discussion

During the 2006 fiscal year, the CalPERS International Equity manager program outperformed its benchmark by just over 1%, continuing the success of the 2005 fiscal year, which outperformed by 2%. This outperformance is at least partly due to the resignation of several managers who had helped cause overall underperformance in fiscal years 2003 and 2004. In addition, the positive results have stemmed from an increased focus on risk-controlled and/or enhanced index managers with high information ratios over the last few years. These newer managers generally have well-controlled and predictable style biases, allowing Staff to better engineer an overall portfolio with the desired risk characteristics and no unwanted overall biases. In addition, Staff's spring-fed pools of international active managers and enhanced index managers have allowed greater flexibility and timeliness in replacing underperforming managers.

We support the annual contract renewal recommendation as the current stable of managers mostly has produced positive active return. Staff has the authority to terminate managers who do not perform as expected, and they have used that authority when

[1] Wilshire's Code of Conduct requires us to disclose which of the above firms are clients of Wilshire's Analytics Services Division and as such pay Wilshire a fee for the licensing of analytical software used in investment management. Wilshire's consulting division has no business relationship with them. This disclosure has been delivered under separate cover and is included as an attachment to this agenda item.

necessary and appropriate. The renewal of these contracts does not in any way preclude Staff from exercising the authority to terminate any manager who ceases to perform as expected subsequent to contract renewal.

Acadian Asset Management

Acadian actively manages an All Country World ex-US portfolio for CalPERS that employs a quantitative process for all stock, sector, country, and currency research, and for portfolio construction and management. Acadian models more than 20,000 stocks in more than 60 markets, and builds portfolios that typically contain 150 to 200 stocks. Multiple on-site reviews of this company conducted by Wilshire over the last year have showed us that this is one of the most advanced investment processes in the industry. The manager was hired in December 2005, and has a short track record with CalPERS, outperforming by 166bp since inception. Longer term, the manager’s composite performance has exceeded the benchmark in each of the last three fiscal years (ended June 30) by approximately 3% to 9%.

AllianceBernstein

AllianceBernstein manages three non-US equity portfolios for CalPERS. The first is the Bernstein Emerging Markets Value Portfolio. Unlike many emerging markets managers who pick a variety of large cap “core” stocks with a few growth and value stocks, this portfolio seeks out the deepest value companies in the emerging markets, using Bernstein’s typical in-depth fundamental research and valuation process. As a result, this portfolio represents the analysts’ and portfolio managers’ highest conviction ideas. This manager was hired in 2002 and has outperformed by 165bp to 1565bp in each of the last three years.

AllianceBernstein also manages large cap growth and value international equity portfolios for CalPERS, benchmarked to the All Country World ex-US index. The two portfolios are essentially mirror images of each other, holding 50 to 75 aggressive growth or discounted value stocks. Both portfolios seek to add value over the benchmark primarily through stock selection, with only incidental value added or lost through country or sector positions. Given the growth and value biases of these portfolios, they should be expected to have divergent performance in short periods, but to outperform the broad benchmark over a long-term market cycle. Since the managers were hired in September 2005, their performance has, indeed, offset each other. Generally speaking, value stocks have outperformed growth stocks over this time period, and this is reflected in the relative performance of the two managers – the growth portfolio underperformed the benchmark by 234bp since inception, while the value portfolio outperformed by 569bp.

AQR Capital Management

AQR combines the concepts of value and momentum to capitalize on the overreactions of other investors in the marketplace to news and mass psychology. The manager uses a series of proprietary global asset allocation and security selection models to affect its investment process. Beyond pure stock selection, the manager also incorporates an industry relative ranking system that feeds back into the security ranking and selection process. This manager was hired in December 2005, and has underperformed the benchmark by 157bp in the first two quarters of management for CalPERS. At the composite level though, the manager has outperformed the EAFE index by 0.50% to 1.50% in each of the last three fiscal years.

Arrowstreet

Arrowstreet was hired in March 2003 to manage a core-oriented All Country World ex-US portfolio for CalPERS. Arrowstreet seeks to take advantage of both behavioral mispricings (value, momentum, technical signals) and informational mispricings (earnings signals), profiting when most investors in the market respond to some new piece of information in a biased, slow, or inefficient manner. Arrowstreet utilizes opportunistic biases (value/growth, large/small, world regional) away from the benchmark as its signals indicate, but will not maintain such biases in a systemic or permanent fashion. Over the last three fiscal years, the manager outperformed by 7% in fiscal 2005 and by 1.4% in fiscal 2006, but underperformed the benchmark by 2.7% and 4.6% in fiscal years 2003 and 2004. Since inception with CalPERS, the manager has just beaten the benchmark, with 34bp of annualized value-added.

AXA Rosenberg

AXA Rosenberg has managed a core European equity portfolio for CalPERS since March 2001. AXA employs a quantitative strategy where the true value of each of 19,000 stocks is recalculated every three minutes, and the portfolio is subsequently optimized based on the results of any changes. Unlike many quantitative managers who employ a multi-factor model which is based on independent assumptions of what makes a stock cheap or expensive, AXA's models price each security based on what the market is paying for such securities. For example, the consumer software portion of Microsoft is valued based on where the market is valuing all the other consumer software companies, and then is added to the business software's valuation based on the current market valuation for business software companies. To the extent that the computed total valuation differs from the current stock price, AXA's models indicate whether the stock should be bought or sold. An equally quantitative methodology is used to predict the future earnings of companies, and this forecast is combined with the valuation model to construct a portfolio of stocks with index-like characteristics but superior growth and valuation. Since inception, this portfolio has had an annualized excess return of 2.50% and has outperformed by 44bp to 479bp in each of the last three fiscal years.

Baillie Gifford

Baillie Gifford manages an active international equity portfolio for CalPERS that exhibits a growth orientation. This portfolio was one of two which were noted by Wilshire in September 2005 for observation. The manager seeks to add value by constructing a portfolio of roughly 100 to 150 names utilizing a bottom-up stock selection process. The stock selection is performed by regional teams and then the overall regional allocation is determined by an Investment Policy Committee. Due to the manager's growth orientation, performance suffered during the 2004 fiscal year. In addition, country/regional selection contributed negatively to performance. Performance improved greatly during the 2005 fiscal year as the manager made improvements on overall portfolio construction during the regional allocation process. These improvements continued to reap rewards in fiscal year 2006, with the portfolio reporting an excess return of 7.44%.

Barclays Global Investors

BGI manages an enhanced index portfolio for CalPERS, which seeks to replicate the general characteristics of the index (i.e., country weights, sector weights, P/E ratio, P/B ratio, market capitalization, growth/value bias, etc.) but add value through superior stock selection. Using quantitative multi-factor models, BGI identifies a few hundred securities which it believes will outperform the benchmark due to either superior growth or valuation, and then constructs an optimized portfolio of these securities. Over time, the vast majority of the value-added and tracking error in the portfolio has been demonstrated to result from stock selection, with little to any variation from the index due to sector, country, currency, or style/size bias. BGI was one of the first institutional investment managers to construct and offer enhanced indexation portfolios, and remains at the leading edge of industry research. BGI was hired by CalPERS in October 2005, and has added 67bp of total value through June 30, 2006. At the composite level, BGI has added 50bp to 115bp of value in each of the last three years.

Baring International Investments

Baring manages an enhanced index portfolio for CalPERS. This portfolio is essentially the exact opposite of BGI, above. Baring adds value solely through macro-economic management and the selection of country and sector over-weights and under-weights. Baring then implements its macro-economic viewpoint through the use of country and sector index funds. As a result, value-added from stock selection is virtually impossible. This investment process is a great diversifier for many of the other managers in the international external equity program, including Acadian, AXA Rosenberg, and BGI who rely on stock selection for most or all of their relative performance. Since inception in November 2005, the manager has added 1bp of value relative to the benchmark. Over longer periods of time, the manager's composite added 1.5% to 2% of value in fiscal years 2004 and 2005, but underperformed by 1.5% in fiscal 2006.

Capital Guardian

Capital Guardian manages a European equity portfolio for CalPERS that, like Baring, serves to diversify the group of investment processes employed by the international managers. Capital is a purely fundamental investment manager, with hundreds of research analysts around the world routinely meeting with companies and government officials. The results of these research meetings is funneled to the portfolio managers, who pick stocks based on which are expected to have the best future performance, with far less regard for country or sector weights than most of the quantitative or enhanced managers in CalPERS' pool. Capital employs a system of multiple portfolio managers, wherein any client portfolio is shared among several portfolio managers, and each picks stocks without consideration as to the stocks selected by other managers. A combination of several sub-portfolios which encompass a variety of investment style results in a total client portfolio which usually has a fair amount of diversification within it. Capital was retained by CalPERS in 2001 and added moderate amounts of value in fiscal years 2002, 2003, and 2004. However, in fiscal years 2005 and 2006, Capital underperformed by 2.60% and 0.24%, respectively. This recent underperformance has resulted in an annualized underperformance since inception of 16bp. Philosophically, Capital's portfolios tend to have a slight growth bias, and many have underperformed over the last few years due to the stronger performance of value stocks. As the cycle inevitably reverts to favor growth, we expect Capital's performance to improve.

Dimensional Fund Advisors

DFA has managed an Emerging Markets portfolio for CalPERS since August 2002. DFA's investment process uses quantitative screens first to identify the most liquid stocks and then to determine which stocks have superior valuation. Country weightings are based on market capitalization and liquidity. There is no specific level of tracking error targeted, but individual positions are usually limited to 4% of the portfolio's value. Much of the firm's value added comes through superior trading of positions, and the firm has made a large investment into the systems and personnel required to execute its strategy. Since hiring DFA, CalPERS' portfolio has experienced positive relative returns in four of the last five years, with the exception being a 5% underperformance in fiscal year 2006.

Despite this poor year, however, the manager is ahead of the benchmark on an annualized basis by 2.24%.

Genesis Asset Management

Genesis manages an Emerging Markets portfolio for CalPERS, and was retained in August 2002. Genesis employs a fundamental research-based investment process which pools the joint resources of ten country specialists. The portfolio is constructed with little regard for the benchmark, and is based on the team's opinion of each of the roughly 300 companies which are monitored and modeled. Since inception, Genesis has added an annualized 71bp of value, and has beaten the benchmark in both fiscal 2005 and 2006. Although the portfolio got off to a slow start after initial funding, and moderately underperformed in fiscal 2003 and 2004, the firm has corrected past mistakes and appears to be on the right track.

Grantham, Mayo, Von Otterloo

GMO has managed a core All Country World ex-US portfolio for CalPERS since June 2001. GMO's investment process derives 65% of its value from stock selection and 35% from country selection. The manager starts with a screen to identify stocks with superior valuation, and then uses a combination of both quantitative analysis and qualitative research to determine which stocks should be in the portfolio. The country decision is based on the comparative valuation one country has versus others. As a result of all of these processes, the resulting portfolio will have a moderate value bias over time. Since inception, the portfolio has added annualized value of 3.99%, but has underperformed in the last two fiscal years by 64bp and 111bp. GMO tends to take macroeconomic positions before much of the rest of the industry, preferring to be early than late. Performance over the last year has suffered as the firm anticipates a decline in commodities prices and has begun positioning for the drop.

New Star

New Star, formerly WorldInvest, was retained by CalPERS in October 2005 to manage a portfolio benchmarked to the All Country World ex-US index. The firm employs a research-driven, fundamental process to identify companies with superior management and growth prospects. The research process closely analyzes each firm's competitive position, quality of management, and ability to increase shareholder value. The firm also makes use of macro-economic data, such as real money flows, to determine which countries and sectors are best positioned for future growth. Since inception for CalPERS, the manager has lost 2.93% relative to the benchmark. On a composite level, the manager outperformed by 2.5% in fiscal 2004 and by 1.6% in fiscal 2005.

Nomura

Nomura was hired in August 1989 to manage a Pacific Basin portfolio for CalPERS, and has the longest tenure of any manager in the portfolio. The portfolio management process flows top-down, with a macro-economic ranking of each country in the Pacific Basin for attractiveness comprising the first step. Sector allocation forms the next major step in the investment process, with local country teams aggregating the results of their stock analysis into sector forecasts which then drive the sector allocations. Finally, each local team of portfolio managers selects the stocks that will go in the portfolio on the basis of a number of metrics (including P/E, P/CF, and P/B) per the constraints imposed by the sector allocation process. This portfolio has added value for CalPERS in four of the last five years, and has generated annualized performance of 4.56% since inception.

Quantitative Management Associates International

QMA was hired by CalPERS in April 2006 to manage an enhanced index portfolio. QMA's investment process uses a quantitative approach to exploit persistent, predictable mispricings. QMA classifies stocks by historical and expected future growth rates, then uses a variety of models which use the expected growth rate to extrapolate a predicted future outperformance for each stock. Finally, an internally developed optimizer is used to construct the portfolio with the maximum expected return, subject to some risk constraints. Targeted tracking error is 2%. Since inception, QMA is 3bp behind the benchmark, but has only been managing CalPERS assets for three months. Relative to the benchmark, the manager's composite has outperformed by 1% to 3.5% in each of the last three years.

Robeco USA

Robeco USA manages an active international equity portfolio that has a slight growth orientation for CalPERS. The manager utilizes a quantitative investment process that combines top-down regional allocation with bottom-up stock selection to add value. Fundamental analysis is used to identify a company's competitive position within its industry, while a quantitative multi-factor model is used to rank stocks. In addition to facing a style-headwind, Robeco's stock selection decisions went unrewarded during the 2003 and 2004 fiscal years. Stock selection improved during the 2005 fiscal year, especially in the Pacific-Basin markets, and the manager added 2.7% over the benchmark for CalPERS in fiscal 2006. This was the other manager selected for special review last year, but has now pulled its performance since inception to within 60bp of the benchmark. Staff and Wilshire will monitor this manager for continued improvement.

Conclusion

Unlike in last year's report, no managers have performed poorly enough to warrant special attention or scrutiny. In a few cases, recent underperformance can be explained by known style (growth/value) biases that should revert over a market cycle, or by particular strategy elements which either did not work as planned or are believed to be early.

Through the on-going activities of both CalPERS' consulting team and Wilshire's Manager Research Group, we closely monitor the performance and investment processes of all of CalPERS' managers. At this time, Wilshire concurs with Staff's recommendation to renew the contracts for all of the international equity managers, as CalPERS still has the right to terminate on 30 days notice.

Sincerely,

Michael C. Schlachter, CFA